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NSC FOR DTOMLINSON
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TAGS: EFIN PGOV VE
SUBJECT: BANKING SECTOR UPDATE: SNAPSHOTS AND
VULNERABILITIES

REF: A. CARACAS 00208

¶B. CARACAS 02322
¶C. CARACAS 00704
¶D. CARACAS 02244
¶E. CARACAS 02067
¶F. CARACAS 00659
¶G. CARACAS 02252
¶H. CARACAS 01739
¶I. CARACAS 01426

Classified By: ECONOMIC COUNSELOR ANDREW N. BOWEN FOR REASON 1.4(B) AND (D).

SUMMARY

¶1. (SBU) From December 2005 to June 2006, reported bank profits (return on equity) declined from 32.5 to 30.7 percent (17 percent real profit after adjusting for inflation, which is in line with bank returns in the region). During this period, the sector has faced increasing regulatory control and declining interest rate yields. Sector vulnerabilities include: heavy regulation of bank assets (e.g. BRV-directed lending requirements), and depending on the bank, large portfolio concentrations of BRV financial instruments and deposits. BRV trusts and investments, which constitute large holdings of public funds in the financial sector, are reported but not included on bank balance sheets. Some banks also reportedly manage a portion of their deposits and loans "off the books," further weakening the sector's transparency. Pending banking legislation looks to reduce bank fees and increase directed lending requirements for microbusiness and housing. However, emphasizing the already strong BRV control over the sector, contacts agree that nationalization of the banking sector remains very unlikely (ref F) for now. End summary.

BANK BALANCE SHEETS

¶2. (SBU) BRV influence is strongly reflected on bank balance sheets, touching every part of their operations. Thirty-two percent of bank loans are directed by law to specific categories: housing (10 percent), agriculture (16 percent), micro-business (3 percent), and tourism (2.5 percent). Financial sector contacts described these categories as risky and noted that the BRV also sets the maximum lending rate for each category (reftel A). As of June 2006, 15 percent of bank assets were held as reserve requirements at the Central Bank (BCV). These funds receive no interest (reftel B). Approximately 45 percent of bank assets are in BRV bonds and BCV certificates of deposits (CDs). In sum, a significant portion of the banking system's assets are under the BRV's influence. (Note: Banks manage their balance sheets (assets and liabilities) to maintain financial solvency and maximize profits. Bank assets refer to items of value owned by the bank, such as loans, investments, cash reserves, and real estate. End Note.)

¶3. (C) With respect to bank liabilities (amounts banks owe to others, such as customers' deposits), BRV deposits represented 23 percent of total deposits held by banks at the end of June 2006. Should the BRV decide to withdraw its funds from the banking sector, as was proposed earlier with the creation of the BRV-owned Treasury Bank, this would greatly affect the sector. (Note: To date, the Treasury Bank has not pulled significant funds from the sector. Any precipitous withdrawal would likely create a panic in the sector. End Note.) However, BRV deposits are not distributed evenly (reftel A). A close contact showed econoffs data for BRV deposits as a percentage of total deposits as of June 2006. The concentration of BRV deposits in smaller banks was impressive: Confererado (71.4 percent),

Bancoro (79.7 percent), Guayana (53.3 percent), and Baninvest (80.7 percent). Larger banks, such as Banesco, Venezuela, Provincial, Federal, and Mercantile also hold large amounts of BRV deposits. The contact, citing Central Bank (BCV) sources, said that approximately 40 percent of BRV deposits in domestic banks "are not moved," allowing banks to profit from using the dormant funds for additional business. He also noted that banks often do not pay the BRV interest because BRV deposits are placed in non-interest earning checking accounts. (Comment: quite a racket, though not necessarily unique to Venezuela. End Comment.)

¶4. (SBU) Financial sector contacts said that foreign banks have a reputation for refusing to bribe BRV officials to obtain BRV deposits (depends on the foreign bank). Seven out of forty-four private commercial and universal banks in Venezuela, accounting for 32.3 percent of bank assets, are foreign-owned. Bank officers for two U.S. banks have told econoffs that they are not actively pursuing BRV business

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PROFITABILITY

¶5. (SBU) Bank profits (return on equity) have declined from 45.1 percent in 2004 to 30.7 percent presently (17 percent real profit after adjusting for inflation and in line with regional returns). In 2004, financial institutions were making huge profits from a special 2002 BRV bond issue, which had a yield of 40 percent. By contrast, banks paid depositors approximately 12 percent for 90-day deposits and 6 percent for savings deposits, earning a handsome, tax-free profit from the marginal difference (reftel C). Today, banks maintain significant investments in BRV bonds and BCV CDs but at lower interest rates than before. For example, nominal interest rates on BRV bond issues are paying around 13.32 pct and BCV CDs pay around 9.92 pct as of May 2006 (Note: official inflation is expected to come in at around 10 pct for the year. End Note.) Furthermore, growing liquidity has pushed interest rates down, limiting the amount that banks can earn for lending activities (reftel D). Directed lending requirements have also led some financial institutions to curb expansion of their businesses to avoid increasing loans

to directed categories, described by many as risky.

¶6. (C) Pedro Coa, the Chief Economist with Banesco, said that consumer credit is the banking sector's most profitable business, but also the riskiest. Coa noted that many in the financial sector believe that foreign banks have their headquarters absorb certain costs to allow them to claim higher profits and then repatriate profits home through the overvalued Bolivar. Foreign banks can request repatriation of dividends at the official rate (overvalued by approximately 20 percent) through the Foreign Exchange Commission (CADIVI), while domestic banks often buy BRV or Argentine dollar-denominated bonds to gain access to what are relatively cheap dollars (reftels E-F). Banks also make handsome profits from service fees.

OFF-THE BOOKS ACTIVITIES

¶7. (C) Trust funds and money market funds, which include large BRV investments, are off balance sheet transactions. (Note: The BRV has issued new regulations to address this issue. See para 8. End Note.) In addition, bank investments in BRV bonds and Argentine bonds are also off the books. According to economist Orlando Ochoa, because banks cannot register foreign exchange bond transactions on their books, banks resort to using related companies or brokerage houses to buy the bonds. Because of concerns over questionable accounting, the headquarters offices of foreign banks tend to object to purchases of these bonds. Esther de Margulis, former President of FOGADE (the Venezuelan

equivalent of the FDIC), told econoffs that many senior bankers (rather than the banks they represent) profit from off the books activities. For example, she alleged that profits on Argentine bonds (reftels E-F) are shared: 50 percent by the Finance Ministry and Treasury officials, 25 percent by intermediaries, and 25 percent by the bank. According to a close contact, the BRV has one primary facilitator, alleged to be Danilo Diaz Granados, who serves as the intermediary between the BRV and financial institutions for deposits and bonds.

¶8. (C) Of greater concern, de Margulis alleged that, some banks create separate companies to hold deposits apart from the banks' balance sheet to avoid registering all of their liabilities. For example, according to de Margulis, there were incidents during her tenure almost a decade ago, when customers would come to a bank to make a deposit and receive deposit receipts with another company's name. De Margulis further alleged that banks sometimes lend from these separate companies to related companies (e.g. to businesses that belong to the bank's board of directors). Acting in her role as FOGADE President to liquidate financial institutions after their collapse in 1994-1995, de Margulis found that some banks' actual liabilities were between 2 to 3 times their declared liabilities. De Margulis is confident, from her current experience as a financial sector consultant, that these practices continue, making measurement of financial sector health difficult. (Note: Another close contact, however, doubted that this magnitude of activity was occurring. Post will continue to examine in future reporting the issue of off-balance sheet transactions and off-balance sheet activities and the role each plays in the economy. End Note.)

NEW BANKING REGULATIONS

¶9. (C) The Banking Association's Chief Economist Jesus Bianco described several recent changes to banking regulations by BRV agencies. The main regulators of the Venezuelan banking system include: the Central Bank (BCV), which implements monetary policy, the Superintendency of Banks (SUDEBAN), which monitors the financial soundness of the sector, and the FOGADE, which provides deposit

guarantees. According to Bianco, the Banking Association negotiated the regulatory changes collectively to mitigate the financial impact of SUDEBAN's new requirement to include money market funds in the balance sheet. Bianco noted that prior to this change, money market funds represented significant liabilities not included in the balance sheet. If included as liabilities, many financial institutions would be considered insolvent.

¶10. (SBU) To help banks adjust to this change, SUDEBAN decreased its equity/(assets minus public bonds) requirement ratio from 10 to 8 percent; banks were given 20 quarters to include all of the liabilities to meet BCV reserve requirements; and the BCV allowed banks to hold 30 percent (rather than 15 percent) of their equity in foreign currency. Many observers remain concerned about a lower capitalized banking industry. However, allowing financial institutions to hold a greater portion of their equity in foreign currency provides financial institutions with some protection against an eventual devaluation and the BRV with a market for its dollar-denominated BRV bonds and for Argentine bonds. To protect their assets against an eventual devaluation, contacts allege that many banks move their capital oversees. However, Rodrigo Cabezas, President of the National Assembly's Finance Committee, claimed to econcouns that the BRV would not devalue in 2007(reftel F).

PENDING LEGISLATION

¶11. (SBU) On July 12, Cabezas told econcouns that reform of the banking law was still under discussion and he expected the bill to pass in 2007, but foresaw no structural changes to the current law (reftel F). The Banking Association is negotiating changes to the Banking Law with the National Assembly. Pedro Almoguera, the Banking Association's Technical Executive Director, said that no one knows why a new law is needed, but speculated that some legislators wanted to include the Credit/Debit Card Law, which died last year and push for more consumer protections. Adding that there is "currently no big issue to discuss," Almoguera said the BRV had apparently abandoned the push to declare the banking sector a "public service," which would have enabled the BRV to completely control the sector. (Note: The National Assembly is now considering a separate new Public Service Law which could impact financial institutions. End Note.) Many observers anticipate that the new banking law will include additional directed lending for microbusiness and housing and limitations on banking fees, which consumer advocates argue are too high. (Note: the Central Bank's Board approved a resolution on August 24 (No. 06-08-01) freezing the fees and commissions banks can charge without prior approval from the Cental Bank. End Note.)

RELATIONS WITH THE BRV

¶12. (C) The banking sector has not openly challenged the BRV and instead has tried to adjust to BRV policies. Pedro Coa, Chief Economist with Banesco, said that banks communicate more with the BCV, SUDEBAN, and BRV than during the last banking crisis. "We are not friends and we are not enemies," he added.

¶13. (C) According to de Margulis, the banking sector asked Victor Vargas (Banco Occidental de Descuento) to lead the Banking Association because of his close ties to the BRV. Victor Gill (Fondo Comun) heads the National Banking Advisory Council (CBN), an organization formed by law to present policy recommendations to the BRV. (Note: Both Gill and Vargas are widely alleged to pay bribes for BRV deposits and are known to have profited handsomely from Argentine bond transactions with the BRV. End Note.) De Margulis said that the banking sector previously had "outstanding relations" with Tobias Nobrega, former Finance Minister and now widely

alleged to be a corrupt financial intermediary. De Margulis described relations with Finance Minister Merentes as good when the BRV issues bonds or completes other transactions that favor the sector. (Note: econoffs have heard that some Chavistas are advocating for Merentes' removal, possibly, in part, due to his complicity in bond sales and banking sector corruption. Mentioned successors include, Rodrigo Cabezas, President of the National Assembly's Finance Committee and Edgar Hernandez Behrens, current VM of Finance and President of BANDES. End Note.)

¶14. (C) On July 12, National Assembly Finance Committee President Cabezas told econcouns that he saw no reason, despite one press report, for the BRV to assume control of the banking sector post December 2006 (reftel F). Most industry contacts agree that the BRV will not formally take over the banking sector or place BRV representatives on financial institutions' boards. The conventional wisdom is that for now the BRV has already largely achieved its regulatory/control objectives over the sector. The local president of a large international bank told econcouns that "so far the Government has been able to align the banking system to their objectives and (the BRV) will try to disintermediate it in government related activities by expanding the (branch) network of the newly created Treasury Bank." He also did not seem concerned about the pending banking bill, noting that it did not limit banks' ability to operate and rather dealt with regulating fees and other issues more populist in nature. In any event, he saw no hint of any potential nationalization.

MONETARY LIQUIDITY

¶15. (SBU) Excess liquidity continues to be a concern for the banking sector. Money supply (M2), which equals currency, checking accounts, savings deposits, and CDs, grew 61.4 percent since July 2005, reaching USD 40.2 billion in July 2006 (Reftels G-H). Jesus Bianco, with the Banking Association, told econoff that the liquidity situation is a problem, but it is manageable. Bianco said that, with currency exchange controls, the public portfolio abroad replaces private sector capital flight as a means to control the monetary liquidity. Bianco described to econoff the strange way that BRV funds circulate in the Venezuelan banking sector, often off the balance sheet. He maintained that the Finance Ministry and the BCV could control this situation if they purchased external public debt or saved money abroad. According to Bianco, the BRV places petroleum income in trusts (worth approximately USD 15 billion) for public spending, e.g. on housing or agriculture. The trusts have investments, which include money market funds (approximately USD 15 billion). Bianco noted that BCV has issued approximately USD 15 billion in certificates of deposits to control monetary liquidity. (Comment: As banks move to place money market funds and trusts on their balance sheets, the impact of the BRV involvement in the system will start to show in the money supply. As is current practice, these funds are not considered part of the money supply. Still, the bank can use these funds to earn profits which affects the money supply. In addition, the practice of some banks to use holding companies to hold deposits may impede the calculation of the money supply. End Comment.)

COMMENT

¶16. (SBU) The lack of transparency in the banking and financial sector hinders a true evaluation of how healthy overall the sector is, and how vulnerable it might be to a large external or internal shock. In the current environment of decreasing interest rate spreads, increased regulation, riskier loans, and fewer good investment alternatives, banks will likely find themselves increasingly squeezed, but still very profitable. It is also not in the BRV's interest to

intentionally provoke a banking crises. It appears for now, however, barring a BRV large-scale intervention or a major decrease in oil prices with its attendant impact on the economy, that banks will continue to be able to profitably juggle their asset and liability portfolios.

WHITAKER